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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1933.

No. 660.

ANNIE SAUDER, ADMINISTRATRIX OF THE ESTATE OF PHILIP SAUDER, DECEASED, ET AL., *Petitioners,*

VS.

MID-CONTINENT PETROLEUM CORPORATION, A CORPORATION, *Respondent.*

BRIEF OF PETITIONERS ON THE MERITS ON WRIT OF CERTIORARI.

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VS.

MID-CONTINENT PETROLEUM CORPORATION, A CORPORATION, *Respondent.*

BRIEF OF PETITIONERS ON THE MERITS ON WRIT OF CERTIORARI.

I.

THE OPINIONS OF THE COURT BELOW.

The opinion of the United States Circuit Court of Appeals, Tenth Circuit (R. 84), sought to be reviewed is reported as *Mid-Continent Petroleum Corpordtion* v. *Sauder et al.*, 67 F. (2d) 9; the dissenting opinion of Circuit Judge McDermott, at page 13 (R. 90). Petition for certiorari was filed on December 15, and certiorari granted January 24, 1934.

II.
JURISDICTION.

1. The date of the decree to be reviewed is September 14, 1933 (R. 99);

2. The petitioners here were the appellees in the Circuit Court of Appeals. The claims advanced and rulings made by the Circuit Court of Appeals, here relied upon as the basis of this court's jurisdiction, are, as follows:

(a) The Circuit Court of Appeals erred in refusing to follow and apply the Kansas decisions to the effect that the implied covenant in an oil and gas lease to fairly exhaust the capability of land to produce mineral, requires that developing be done by drilling, and that if the land will not produce minerals or the lessee is not justified in drilling, he cannot continue to hold it by virtue of a provision extending the lease term so long as oil or gas be produced in paying quantities; and thus has:

(1) Departed from the accepted and usual course of judicial proceedings and created a conflict of decisions between the various Circuit Courts of Appeal;

(2) Decided an important question in a way probably untenable and in conflict with the weight of authority and of the principles announced by this court;

(3) Brought about a situation where diverse citizenship, instead of preventing a discrimination against a non-citizen, results in a discrimination in his favor and against the citizen, and, instead of making one law for all in a state, makes different laws for a citizen and a non-citizen, thus making a bewildering confusion which has incited a demand to abolish Federal jurisdiction based on diverse citizenship;

3. The jurisdiction of this court is invoked under Sec. 240 of the Judicial Code, as amended by the Act of February 13, 1925, 43 Stat. 938 (28 U. S. C. A. 347);

4. The cases believed to support the jurisdiction of this court are:

Edward Hines Trustees v. *Martin,* 268 U. S. 458, 45 Sup. Ct. Rep. 543, 69 L. Ed. 1050.

Black & W. Taxicab Co. v. *Brown and Y. Taxicab Co.*, 276 U. S. 518, 48 Sup. Ct. Rep. 404, 72 L. Ed. 681.

Guffey v. *Smith,* 237 U. S. 101, 35 Sup. Ct. Rep. 526, 59 L. Ed. 856.

Hartford Ins. Co. v. *Railway,* 175 U. S. 91, 20 Sup. Ct. Rep. 33, 44 L. Ed. 84, 89.

III.

STATEMENT OF THE CASE.

The petitioners are the heirs at law of Philip Sauder, who brought this suit to cancel the undeveloped portion of an oil and gas lease on 360 acres of land located in Greenwood County, Kansas (E ½; and SE ¼ SW ¼, Sec. 16, Twp. 23 South, Range 13 East), for failure to explore and develop, which lease, by mesne assignments, had passed to the respondent, Mid-Continent Petroleum Corporation, a Delaware corporation (R. 15-20).

The trial court entered a decree canceling said lease except as to a tract 860 feet east and west and 400 feet north and south located in the SE ¼ SW ¼, on which two producing wells had been drilled (R. 42-3). On appeal, the United States Circuit Court of Appeals, Tenth Circuit, reversed said decree without

prejudice to the bringing of a new suit in the event changed conditions should indicate a breach of the implied covenant to develop. The majority opinion by Circuit Judge Phillips is found at R. 84-90, and the dissenting opinion by Circuit Judge McDermott at R. 90-8.

The lease, dated June 6, 1916, for the consideration of $1.00, granted to the respondent's predecessors in interest,

> "The exclusive right * * * to enter upon, operate for and procure oil and gas, * * * *for 10 years from date * * * and as long thereafter as oil and gas can be procured thereon in paying quantities,*"

on 360 acres of land described, as follows:

> East Half (½) of Sec. 16, Twp. 23, R. 13, acres 320; Southeast ¼ of Southwest ¼ Sec. 16, Twp. 23, R. 13, Acres 40.

The lessors were to receive:

(a) One-eighth of the oil realized from the premises in tanks or the market price in cash;

(b) On demand sufficient gas for domestic purposes (if sufficient gas is found in any well or wells producing gas only to justify the expense of saving and casing same);

(c) $100.00 per year for and during such time as gas shall be sold or marketed (if lessee shall market or sell gas from any well producing gas only);

Lessee (respondent) was to receive:

(a) Free gas or oil for drilling or operating all machinery;

(b) The remainder of all of the gas;

(c) Privilege of using sufficient water from any creek, branch, lake, or pond on the premises; if neces-

sary to drill therefor or make ponds, to run all necessary machinery for drilling and prospecting for oil and gas and operating same;

(d) Exclusive right to erect, lay, and maintain upon the premises, all pipe, pipe lines, machinery, and structures necessary for the production, preservation or transportation of oil and gas or to remove the same;

(e) The right to discharge any incumbrance on the premises and have a lien for the amount so paid and necessary costs and expenses" (R. 6-8).

With reference to the commencement of drilling, the lease provides that:

> "In case no well be commenced on said premises within one year from date hereof, all rights and obligations secured under this contract shall cease upon notice in writing from the said first parties. Provided, however, that the said second parties shall have the right to continue this lease in force from year to year, until a well is drilled thereon, by paying at any time within ten days from date of the service of said notice, an annual rental of $1.00 per acre for said premises. Said rental to be deposited to the credit of said first parties in Citizens State Bank in Gridley, Kansas, payable quarterly in advance" (R. 7).

The lease further provided that:

> "If Oil or Gas be found on these premises by said second parties, all rights, benefits, and obligations secured hereby shall continue so long as either can be procured in paying quantities" (R. 6-7).
>
> "This Contract Shall extend to and be binding upon the heirs, assigns, successors and personal representatives of the parties hereto. Executed in duplicate the day and year first above written" (R. 8).

On November 1, 1921, and January 1, 1922, during the primary term of the lease, predecessors of the respondent completed two wells in the SE ¼ SW ¼ Sec. 16, which have ever since produced, and now produce, oil in paying quantities. Each of these was an offset well to producing wells located in the NW ¼ of Sec. 21 and the SW ¼ of Sec. 16 (R. 23). There has been no further drilling on the Sauder lease during the 17 years since its execution (R. 21, 33-4, 48, 53; Exh. 1, R. 66-A, 22). Seven-eighths of the total revenue, which accrued to the operator from the Sauder lease up to December 31, 1931, was $72,694.18; the total expenditures for drilling, equipping and operating were $46,464.97; leaving a profit to respondent of $26,229.21 and an average rate of earning on the basis of expenditures of 5.1 per cent per annum (R. 48). It cost $15,000.00 to $16,000.00 to drill and equip each well (R. 48). Reference will be made in the argument to show the fallacy of this testimony with reference to the rate of return. The lessors have received between $9,000.00 and $10,000.00, a part of the payments being, as follows:

1927	$760.50
1928	658.45
1929	623.90
1930	495.43
1931	239.23
1932	258.00

The petitioners' evidence proved the location, date of drilling, depth and initial production of the wells drilled on land bordering upon the land involved. It showed, and the court found, producing wells, as follows:

To the North and East—in the SW ¼ of Sec. 10—16 wells; *To the East*—in the half section lying immediately east of the half section involved, being W ½ of Sec. 15—25 wells; *To the Southeast*—in the NW ¼ of Sec. 22—12 wells; *To the South*—on the half section lying immediately south of the land in question, being N ½ of Sec. 21—10 wells; *To the Southwest*—in the NE ¼ of Sec. 20—6 wells; To the West—in the SW ¼ of Sec. 16 and the SE ¼ of Sec. 17—7 wells. There are also two other scattered wells to the West and two to the North of the land in question. None of these wells is within 400 feet of the land in question except those to which the two wells in the SW ¼ of Sec. 16 are offsets. They are within 200 feet south and west thereof (Exh. 1, R. 66-A, 34).

Defendant's Exhibit E (R. 72-A) also shows these additional producing wells: 10 in the SE ¼ of Sec. 10; 18 in the East half of Sec. 15; 5 in the NE ¼ of Sec. 22; 11 in the South half of Sec. 21; and approximately 40 in a southwesterly "trend" from the Sauder lease in Sections 20, 29 and 32. The East half of the Sauder lease is the only tract in a "trend" running northeasterly and southwesterly for a distance of 5 miles which does not have oil production (R. 56-8, 66-A). Of the 22 wells drilled on the land adjacent to the Sauder lease on the Southwest, two were drilled prior to the Sauder Number One. Of the 13 wells on the land adjacent to the Southeast, one was drilled prior to Sauder Number One. Of the 25 wells on the land adjacent on the half section East, none was drilled prior to Sauder Number One. Of the 20 wells drilled on the land adjacent on the Northeast,

one was drilled prior to Sauder Number One (Plff. Exh. 1, R. 66-A).

The respondent owns and is operating the SW ¼ of Sec. 15, lying East of the land in question, containing thereon 9 producing wells; also the NW ¼ of Sec. 22, lying Southeast of the land in question, with 12 producing wells thereon, and the North half of Sec. 21, lying immediately South of the land in question, with 9 producing wells thereon (Exh. 1, R. 66-A).

The wells to the East of the Sauder lease are producing from the Bartlesville sand and Mississippi lime, the major portion being from the Bartlesville sand which is found in long, narrow strips averaging about 3 well locations (a width of 460 feet per location) (R. 49, 55). The best wells were had by drilling in the middle or crest of this sand and the locations to the West toward the East side of the Sauder lease, or to the East in the opposite direction, showed the sand to be thinner with more water and less oil (R. 50, 51, 55, 60).

The wells on the Sauder lease and those to the South, West, and Southwest, are producing from the Mississippi lime, which underlies the Bartlesville sand (R. 51, 55, 59, 60-3, and 64). A geologist, who had never been on the lease involved, gave as his opinion that there was an absence of oil in paying quantities in the Mississippi lime underlying the Sauder lease, for the following reasons: (1) "Said lime formation produces oil at a higher point and is barren of oil at its lower points; that is, the oil is found where the lime is near the surface (R. 61-2); (2) The formation dipped in every direction except from the Northwest to the Southwest (R.

61); (3) Wells encountered in the lime at a greater depth than 570 feet below sea level in the vicinity of the Sauder lease were usually dry holes or produced oil in negligible quantities (R. 60-1; Exh. E, R. 72-A); (4) Three dry holes were drilled near the Sauder lease, one in the SE ¼ of Sec. 9, 1,880 feet North of the North line and 200 feet West of the East line extended of the Sauder lease; one in the NW ¼ of Sec. 16, 630 feet West of the West line and 290 feet North of the West line of the Sauder lease, and 290 feet North of the center line of Sec. 16; another in the SW ¼ of Sec. 16, 200 feet West of the West line and a thousand feet North of the South line of the lease; and a well in the SW ¼ of Sec. 15, 750 feet East of the East line of the Sauder lease did not produce oil in paying quantities. The two wells drilled in the Sauder lease reached the lime at 558 and 574 feet respectively (R. 50-1, 56, 72-A, Exh. E). Some of the wells to the Northeast are producing from the Bartlesville sand and some from Mississippi lime (R. 59).

The lime under the Sauder 320 acres is from 570 to 610 feet below sea level and much of the South half is between 570 and 590 feet below sea level (R. 72-A, Exh. E). In the section adjoining on the Southwest (E ½ of Sec. 20 and W ½ of Sec. 21) there are 23 producing wells where the lime is between 570 and 610 feet and 9 wells higher than 570 feet. In Sec. 29, lying next farther Southwest, there are 20 producing wells between the 570-610 feet range and in the field adjoining on the Northeast there are 17 producing wells within the 570-610 feet range and 3 higher than 610 feet. There

are dry holes between 590 and 610, but there are also dry holes as high as 564 feet (Exh. E, R. 72-A).

The respondent, defendant below, introduced opinion evidence of its Vice-President in charge of production, its District Superintendent in charge of production, a geologist in its employ, and the Superintendent of another drilling company to the effect that, taking into consideration the development both on the lease and surrounding leases, the cost of drilling and equipping a well, and the probability of encountering paying production and other available facts, that no prudent operator would have drilled another well on the Sauder lease (R. 51, 55, 61, 65). The Vice-President testified that the dry hole at Theta well No. 2, located 1,880 feet North of the North line of the Sauder lease, and the small production at Viola M. Griblin "B," No. 1, 760 feet South of the South line of said lease, tended to prove that oil did not exist in paying quantities under the Sauder lease (R. 50). On the question of drainage, the testimony was that no wells around the lease involved on adjoining properties would be called "offset wells" (Moody, R. 55) and Snyder, respondent's district superintendent, "did not think" that the wells around the lease involved that had been pumping from 8 to 11 years, were draining oil from under the Sauder lease (R. 58). Generally these witnesses testified as to their opinion founded on practical experience and watching developments, but stated that their theories might be wrong; that they did not want to tell the court that they could tell where there was oil; and that if a well had been drilled in the middle of the lease involved, information could have been se-

cured which was not now possessed and such information might change the facts upon which their theories and conclusions were based; and that the only way to be absolutely certain as to whether there was any oil in the lime under the involved half section was by drilling a well (R. 54, 56-7, 62-3); that oil had been produced in Greenwood County for years (R. 58).

The respondent's evidence also showed that the half section in question was worthless from the standpoint of future development (Moody, R. 52), but Geologist Young testified that he would not say that the half section was undoubtedly worthless from an oil standpoint (R. 62); that if it were later developed that production could be obtained, the defendant would be willing to develop it; but the purpose of the defendant was to hold the lease without any further development, or until somebody else developed something or until it gained information itself, but it had no immediate intention of developing the lease involved; and that its geological record showed that the Northwest corner of the lease had not been developed as thoroughly as around the edges of it, and that it was not impossible of further development in the Northwest corner (R. 52-3).

On June 16, 1926, Sauder wrote a letter to the defendant, in substance calling attention to the expiration of the 10 year term of the lease; that respondent was supposed to operate, and in effect demanding that respondent explore and develop or in the alternative release its claim to the land except upon that part upon which the two wells had been drilled and were producing oil. On June 25, 1926, respondent replied by letter stat-

ing that, in substance, it considered the lease a valuable one and would not surrender it.

The trial court made findings of fact on all material questions, including a general finding of each and all other issues of fact involved in favor of the plaintiffs and against the defendant (R. 33-36). The findings on matters as to which there is a specific controversy being as follows:

A. None of the oil wells referred to in the above finding are within four hundred feet of the property line of the land described in the lease with the exception of wells to the south which have been offset by the two wells drilled upon this property. The defendant introduced the evidence of expert witnesses who testified rather positively that in their judgment none of the production adjacent to the land described in this lease is draining any oil from the plaintiff's land. These witnesses, however, admitted that they might be mistaken as there was no absolute way of determining the question of drainage except by drilling tests. This evidence as to drainage is not wholly convincing to the court. There is, in the opinion of the court, some probability that damage is being done to this leasehold by drainage upon the adjoining properties (R. 34);

B. On the basis of the oil development and oil production upon adjacent lands, as shown by the evidence herein, plaintiffs contend that a well-defined "trend" of oil producing sand and lime runs in a southwesterly-northeasterly direction under and across the land described in said lease. Expert evidence introduced by the defendant tended to prove that no such "trend" exists under and across the land described in said lease, but that on the contrary the oil sand is not to be found under said land and the depth of the lime under said

land, as estimated by geologists, is so great that the probabilities are no oil would be found in it. On this point the court is unable to determine the facts but finds that no positive evidence having been introduced by either party as to this contention of plaintiffs, that nothing but exploration and positive test by drilling upon said land can settle the controversy as to whether oil and gas in paying quantities can be found upon said land. Neither the defendant nor any of its predecessors in title have drilled any well upon the east half of Section Sixteen (16) but no dry well has been drilled on any of the property covered by said lease (R. 35);

C. On the 16th day of June, 1926, Philip Sauder, then the owner of the land described in said lease, wrote a letter to the defendant in substance, calling the attention of the defendant to the expiration of the ten year term of said lease, and that no wells had been drilled except the two wells heretofore mentioned and demanding that the defendant proceed to explore and develop said land by the drilling of additional wells, or in the alternative that the defendant "release" its claim to all of said land except that part upon which the two wells had been drilled and were producing oil. On June 25, 1926, the said defendant replied to said letter from Philip Sauder, in which letter it stated, in substance, that it considered said lease a valuable one and would not surrender the same (R. 35-6);

D. No effort has been made by the defendant since said letters toward exploration or development by the drilling of wells or otherwise and the evidence in this case shows that the defendant and its officers and employees have no present intention of further exploring or developing said lease and no intention ever to further develop said lease unless and until further developments in the im-

mediate vicinity thereof might convince said defendant and its officers and agents that it would pay the defendant to further explore or develop said lease (R. 36);

E. Evidence of the defendant tends to show that the land covered by the lease in the instant case is worthless for oil drilling purposes (R. 36);

After stating that,

> "If the lease is worthless, as contended by the defendant, it is neither equitable nor just to permit the defendant to continue to hold the lease except upon the 10 acres where the two offset wells are located" (R. 36),

and,

> "I think the question of the defendant's diligence in exploring the premises is of paramount importance" (R. 37),

and,

> "I am compelled to conclude that the defendant in the instant case has not shown that diligence *and* (in) exploring and developing the land in question as is required under the law, equity and good conscience" (R. 39),

the court concluded as a matter of law that:

1. Under the facts and circumstances in this case, as shown by the evidence and the record, the plaintiffs have no adequate remedy at law;
2. The defendant and its predecessors in title have not in good faith and with reasonable diligence explored and developed the lands described in this lease in accordance with the express and implied covenants of said lease;
3. It would be inequitable and unjust to permit the defendant to hold, keep, and retain the leasehold property involved herein without further explora-

tion or development, as said defendant proposes to do, as shown in the pleadings and evidence herein;

4. The plaintiffs, under the evidence, are entitled to a judgment of this court canceling said lease as to all the land described therein except the southwest quarter of the southeast quarter of the southwest quarter of said section Sixteen (16) upon which the two offset wells heretofore mentioned were drilled and developed by defendant or its predecessors in title;

5. The defendant is entitled to hold and enjoy its leasehold rights upon said ten acres of land described in Conclusions of Law No. 4 herein so long as it produces gas or oil therefrom in paying quantities;

6. I find each and all of the other issues of law involved herein in favor of the plaintiffs and against the defendant, to all of which findings and conclusions and each and every part thereof the defendant objects and excepts and its exceptions are allowed (R. 39-40).

The Circuit Court of Appeals held that there was an implied covenant on the part of the lessee to drill such wells as under the circumstances an operator of ordinary prudence, having regard for the interests of both lessor and lessee, would drill; that the trial court did not find that the Petroleum Corporation had breached such implied obligations and that such a finding would have been wholly without support from the evidence (R. 88-9).

The Supreme Court of Kansas, in *McCarney* v. *Freel*, 121 Kan. 189, 246 Pac. 500 (decided June 12, 1926), had applied a different measure of diligence to the implied

covenant to develop. There it held that a lessee could not hold a lease on 160 acres by drilling a single producing well, that there was an implied covenant fairly to exhaust the capabilities of the land and produce the minerals, and that if the undeveloped part will not produce minerals in paying quantities, and the lessee is not justified in drilling more wells, he cannot continue to hold by virtue of a provision in the lease extending the term to so long as oil or gas be produced in paying quantities (R. 89).

The majority opinion held that the trial court's decision was predicated on *McCarney* v. *Freel* (*supra*) conceded by counsel to support the trial court, distinguished it from the case at bar because there the decree was predicated on a breach of the implied covenant whereas there was no breach in the instant case and further held that since *McCarney* v. *Freel* (*supra*) was decided long after the Sauder lease was entered into, that that opinion was not binding upon the Federal courts and, as that court could not subscribe to the doctrine of *McCarney* v. *Freel* because it imposed a greater obligation under the implied covenant to develop than is recognized by the great weight of authority or placed an obligation on the lessee not imposed by the lease contract, it would exercise its own independent judgment as a court of equity. It therefore followed and applied the principles announced by it in *Denker* v. *Mid-Continent Petr. Corp.*, (C. C. A. 10) 56 F. (2d) 725, a case decided in 1932 and involving an oil and gas lease on Oklahoma land (R. 89-90).

Circuit Judge McDermott, dissenting, held that the rights of a holder of an oil and gas lease constitute rules of property to be governed by decisions of the Kansas court; reviewed the Kansas cases both prior and subsequent to the execution of the Sauder lease, and held that *McCarney* v. *Freel* did not overturn any settled rule of property law in Kansas, but is in accord with the current of Kansas authority (R. 91-2), and that either before or after 1916, the date of the Sauder lease, the Kansas court would not permit a lessee to hold 320 acres of land for 17 years without exploration or development and that the Federal Court should apply the Kansas law and cancel the undeveloped part of the lease (R. 94-6); that if he were wrong in his construction of the earlier Kansas decisions, the question was at least an open one at the time the interest in the real estate was acquired, and in that event the rights of the parties should be governed by the later decisions of the Kansas courts in 1918 and 1926 rather than by the later decision of the Federal Court in 1932; that if the lessee of the Sauder lease were a resident of Kansas, the lessor would be entitled to cancellation, and that the majority was permitting a non-resident corporation to acquire a greater interest in Kansas real estate than a resident might acquire (R. 96).

Circuit Judge McDermott further held that if the Kansas decisions are to be ignored the same result should obtain, because a prudent operator, having regard for the interests of the lessor as well as his own, ought not to hold 320 acres almost surrounded by oil wells, without drilling a test well, and that in common fairness he

ought to give the lessors a well or get off and let someone else drill it; that tying up a half section of land for 17 years without drilling a single exploratory well, and with no hope of one unless some other operator drills on adjoining land, does not square with "due regard for the interest of the lessor" and constitutes a breach of the implied covenant diligently to explore and develop (R. 97-8).

IV.

SPECIFICATION OF ERRORS.

1. The Circuit Court of Appeals erred in refusing to follow the Kansas decisions which established the obligation of a lessee under an oil and gas lease to explore and develop (R. 84-90).

2. The Circuit Court of Appeals erred in holding that there was no breach of the implied covenant to explore and develop (R. 84-90).

V.

ARGUMENT.

A. The Circuit Court of Appeals Erred in Refusing to Follow the Kansas Decisions Which Had Established the Obligation of the Lessee Under an Oil and Gas Lease to Explore and Develop.

1. An oil and gas lease in Kansas grants such an interest in real estate as to have a permanent location.

Although an oil and gas lease must be interpreted in the light of its own provisions (*Gas Co.* v. *Neosho County*, 85 Kan. 335, 89 Pac. 750; *White* v. *Green*, 103

Kan. 405, 173 Pac. 974) the Kansas Supreme Court held in *Haggard* v. *Wheeler*, 116 Kan. 702, 229 Pac. 357, that an oil and gas lease, similar to the lease in the case at bar, was such an estate or interest in land as to be the subject of a suit to quiet title under a Kansas statute, which provides:

> "Action may be brought by any person in possession by himself or tenant of real property, against any person who claims an estate or interest therein, adverse to him, for the purpose of determining such adverse estate or interest (R. S. 1923, 60-1801)."

The form of action was questioned and the argument made that the action was in substance one to cancel the lease, but it was the holding of the court that the lease was such an estate or interest in the land that a suit to quiet title was proper when leveled against the lease.

In *Strickler* v. *Stanford*, 109 Kan. 43, 197 Pac. 866, it is said:

> "It is settled in this state that a lease conveying the oil, gas and minerals found in and under lands, together with the right to enter upon the land and remove the same, is a conveyance of a part of the realty. (*Zinc Co.* v. *Freeman*, 68 Kan. 691, 75 Pac. 995, and cases cited in the opinion.)" (l. c. 45.)

In *Brinkman* v. *Empire Gas and Fuel Company*, 120 Kan. 602, 245 Pac. 107, the interest granted by an oil and gas lease was stated to be a *profit a' pendre*, which is very definite interest in and touching upon real estate.

By statute an oil and gas lease in Kansas, is such an interest as to support a contractor's lien for labor or material (R. S. 1923, 55-207).

In *Derby Oil Company* v. *Bell,* 134 Kan. 489, 7 Pac. (2d) 39, it was held that an ordinary oil and gas lease is a conveyance of such an interest in real property as to come within the provisions of the real property recording act, which provides:

> "Every instrument in writing that conveys real estate or whereby any real estate may be affected, proved or acknowledged, and certified in the manner hereinbefore prescribed, may be recorded in the office of the Register of Deeds of the County in which such real estate is situated. * * *" (R. S. 1923, 67-221.)

It has also been held that the right transferred by an oil and gas lease constitutes an alienation of a homestead and that the consent of a husband and wife is necessary to its validity. *Palmer* v. *Parrish,* 61 Kan. 311, 59 Pac. 640; *Thomas* v. *Milliken,* 93 Kan. 72, 143 Pac. 430. The interest created by such a lease has also been defined as incorporeal hereditament, *Robinson* v. *Smalley,* 102 Kan. 842, 171 Pac. 1155.

A very enlightening discussion of just what interest or right is created by an oil and gas lease is contained in the opinion by Chief Justice Johnson in *White* v. *Green,* 103 Kan. 405, 173 Pac. 974, where, after distinguishing between leases which conveyed the title to, or mineral contained in, the land and a mere license to explore, it was said:

> "Although the right granted herein may not have accomplished a severance of the mineral, nor arise to the dignity of what is termed an estate in land, it did give the lessee an exclusive and assignable right to the use of a portion of the land for a period of at least five years. With it went the right to

> use so much of the surface for laying pipe lines, erecting buildings, tanks, stations, and other structures as was necessary to accommodate the oil and gas taken from the wells which the lessee contracted to drill. Thus the lessee has, not only the right to drill for mineral, but he has the absolute right to possession of a part of the land on which to care for the mineral produced. This is a right which no one can take from him during the period of the lease if the required conditions are performed. As will be observed, the provisions of the grant were extended, not only to the heirs and assigns of the lessee, but also to those of the lessor. While the lease may not have given title to the mineral in the land, it did give something in connection with the land which was capable of being inherited. In a number of cited cases it has been designated as an incorporeal hereditament. It is a grant in the nature of an easement, and it is something which may be inherited, and which the law and good public policy require shall be committed to writing * * *"

Since *Swift* v. *Tyson*, 16 Peters 1, 10 L. Ed. 865, where by specific language the binding effect of state law was recognized as to "rights and titles to things having a permanent location, such as rights and titles to real estate, and other matters movable and intra-territorial in their nature and character," and through later decisions of this court, those matters affecting rights and interests to, or essentially touching upon real estate or matters local in nature, have been controlled by state law.

From the Kansas cases cited above, it is easily observed that while an oil and gas lease may not convey what is technically described as an estate in land, it does grant to the lessee a right and an interest in land, sometimes called an incorporeal hereditament, or a

profit a' pendre. It creates such an interest and right as to have a connection with and become a part of, the realty. It has a definite and fixed location, "immovable and intraterritorial in its nature and character."

In *Thurlow* v. *Waite-Phillips Oil Co.* (C. C. A. 8), 22 F. (2d) 781 (1927), the court held that an oil and gas lease involved title to real estate in Kansas, and it was bound to follow the state decisions even though a Federal court disagreed with the local law (785); and in *Harrell* v. *United Carbon Co.* (C. C. A. 5), 52 F. (2d) 790, an action to cancel an oil and gas lease on land in Louisiana, where no well had been drilled within the five year primary period, the Court held that it was bound by a decision of the Louisiana Supreme Court upholding the contention of the appellant, even though it was rendered after the cause was argued in the Circuit Court of Appeals. The Sauder lease in question, giving the respondent the right to explore for oil and gas, the right to possession for those purposes, being perpetual in character under its terms, and extending to and binding the heirs, assigns, successors, and personal representatives of the parties, comes squarely within the principles announced by the foregoing authorities.

2. The Kansas decisions with reference to the obligation to explore and develop, constitute rules of property, are binding on the Federal Court and should be followed by it.

Since the rights and interests created by an oil and gas lease in Kansas constitute rules of property local in nature, touching upon and a part of realty, and possess-

ing a permanent location, the laws of Kansas as announced by the line of Kansas decisions hereinafter stated and analyzed in section A-3 of this brief, should have been followed by the Circuit Court of Appeals as binding upon its decision in this case.

Swift v. *Tyson,* 16 Peters (U. S.) 1, (1842), 10 L. Ed. 865 (Note 1), is the fountain-head of the law relating to the binding effect of state decisions in Federal courts. In announcing the doctrine of that case, Mr. Justice Story exempted from its application and left under the binding effect of state decisions, rights and titles to things having a permanent location "and other matters immovable and intraterritorial in their nature and character" (l. c. 18). That case further excepted the field of law governed by rules of a local nature, and not predicated upon general common law.

That local rules of property are binding on the Federal courts is amply sustained by the following cases: *Warburton* v. *White,* 176 U. S. 484, 20 Sup. Ct. Rep. 404, 44 L. Ed. 555; *Abraham* v. *Casey;* 179 U. S. 210, 218, 21 Sup. Ct. 88, 45 L. Ed. 156; *Walker* v. *State Harbor Commission,* 87 Wall. 648; *Barrett* v. *Holmes,* 102 U. S. 651,

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Note 1: Since that time the subject has been one of much comment and extensive litigation: **Warren, History of Federal Judiciary Act of 1789, 37 Harvard Law Review, 49; Pepper, The Border Line of Federal and State Decisions; William Trickett, The Non-Federal Law Administered in Federal Courts, 40 Am. L. Rev. 819; Frankfurter, Distribution of Judicial Power between United States and State Courts, 13 Cornell Law Quarterly, 499; Sharp and Brennan, The Application of the Doctrine of Swift v. Tyson since 1900, 4 Indiana Law Journal 367; Meigs, Decisions of the Federal Courts on Questions of State Law, 45 Am. L. Rev. 47; 1 Beale, Conflict of Laws (1916) Sec. 112a; Dobie, Federal Procedure (1928) Sec. 142; Note 40 L. R. A. (N. S.) 380; Note 71 A. L. R. 1102; Note 57 A. L. R. 435.**

26 L. Ed. 291; *Bucher* v. *Cheshire Rwy.*, 125 U. S. 555, 8 Sup. Ct. 974, 31 L. Ed. 795; *East Central Eureka Company* v. *Central Eureka Company*, 204 U. S. 266, 27 Sup. Ct. 258, 51 L. Ed. 476; *Hartford F. Ins. Co.* v. *Chicago, M. & St. Paul R. Co.*, 175 U. S. 91, 44 L. Ed. 84, 89, 20 Sup. Ct. Rep. 33; *Brine* v. *Ins. Co.*, 96 U. S. 627, 24 L. Ed. 858. A Federal court was held bound by Kansas state decisions as to whether an oil and gas lease of riparian land carries the right to drill in land formed by accretion. *Thurlow* v. *Waite-Phillips Oil Co.* (C. C. A. 8), 22 F. (2d) 781, certiorari denied 278 U. S. 598, 49 Sup. Ct. 8, 73 L. Ed. 528, and the decision of the state court upon a question peculiar to mining leases was followed in *Foster* v. *Elk Fork Oil & Gas Company*, 32 C. C. A. 560, 90 Fed. 178.

The exception to *Swift* v. *Tyson* has been extended to include questions relating to rights in personal property.

Dooley v. *Pease*, 180 U. S. 126, 21 Sup. Ct. 329, 45 L. Ed. 457.

Bryant v. *Swofford Co.*, 214 U. S. 279, 29 Sup. Ct. 614, 53 L. Ed. 997.

In *Guffey* v. *Smith*, 237 U. S. 101, 35 Sup. Ct. 526, 59 L. Ed. 856, a case in equity, it was held where an oil and gas lease under the decisions of Illinois state court constituted an interest in realty, that the decisions of the highest courts of the state in which the property is situated are accepted and applied by the Federal courts as rules of property.

It should be observed that it is the rule of this court that "the construction and effect of a conveyance be-

tween private parties is a matter as to which we follow the court of the state." *East Central Eureka Company* v. *Eureka Co., supra,* l. c. 272. That is a principle announced by this court as early as *McGoon* v. *Scales,* 9 Wall. 23, followed in *Brine* v. *Ins. Co., supra,* and applied in *American Brake Shoe Company* v. *New York Ry. Co.,* 278 Fed. 842 (1922), as to construction of a lease.

Judge Phillips, writing for the majority in the case at bar (R. 91), prefers to disregard the Kansas rule because three of the cases (*Alford* v. *Dennis, Webb* v. *Croft, McCarney* v. *Freel; infra*) were decided after the lease between the parties was made (R. 96). That position was sought to be justified by the authority of *Kuhn* v. *Fairmont Coal Company,* 215 U. S. 349, 30 Sup. Ct. 140, 54 L. Ed. 228.

It is to be noted that in the case at bar there was a line of Kansas cases in existence before the lease was made, all of which established the Kansas rule contended for. In addition, there were two cases decided immediately after the lease was made, the language of which was very much in point, followed by the *McCarney* v. *Freel* case, all of which were decided from 14 to 6 years before *Denker* v. *Mid-Continent Petr. Corp.,* 56 F. (2d) 725, 84 A. L. R. 756, which is principally relied upon by the Circuit Court of Appeals in reaching its result in this case. The Denker case arose from the District Court of Oklahoma, and it is a fair inference that the trial court was applying Oklahoma law, and the citation of authorities in opinion of the Circuit Court convinces that it was likewise applying Oklahoma law. It cannot be the purpose of the Kuhn case to impose upon resi-

dents of Kansas the rule of property of Oklahoma, adopted by the Federal Circuit Court of Appeals, in a case arising from that state.

The Denker case was decided two years after the case at bar was filed, and sixteen years after the instant lease was made. Thus, while in the case at bar the line of state decisions commenced before the lease was made, and continued after its execution, all the decisions were made a considerable time before the case at bar was filed.

The question certified in the Kuhn case was whether a single state decision, decided after the Federal action was brought, was decisive in an action in the Federal court (215 U. S. at 356). It was held that the state decision did not bind the Federal court, which could decide the question according to its own law, but having regard for the state decision. Three Justices dissented from the doctrine and the result reached in that case.

In the Kuhn case, there was only a single state decision ruling on the proposition of law, and that made after the action in the Federal court had commenced. The rule of applying the state law in the Federal courts, where property rights are involved, has required that the state law be an established rule of property. The Federal courts hesitate to follow a single or individual decision of the state courts, and prefer to follow a line of decisions establishing a rule. *Lane* v. *Vick*, 3 How. 464, 11 L. Ed. 681; *Chesko* v. *Delaware & H. Company*, 218 F. 804; *Pineland Club* v. *Robert* (C. C. A. 4) 213 F. 545, 556; *Lewis* v. *Atwood*, 228 F. 753.

It is a great distance from Kuhn vs. Coal Company to the case at bar, and it must first pass the hurdle of the unanimous decision of this court in *Edward Hines Trustees* v. *Martin,* 268 U. S. 458 (1925), 45 Sup. Ct. 543, 69 L. Ed. 1050, which was apparently not considered by the Circuit Court of Appeals. That case was an *equitable* action to remove a cloud on title to some real estate, and it was held that repeated decisions of the state courts, establishing a rule of property in the state, will be followed by the Federal courts without inquiry into the correctness of the rule as an original question.

In that case, the petitioners' title depended upon a patent issued June 27, 1871, and the defendant's title was acquired through a second patent of December 7, 1883, both patents being issued by the State of Mississippi. *Thereafter,* by cases decided in 1888, 1917, and two cases in 1924, the Supreme Court of Mississippi made decisions determining the law governing the rights and title to land proceeding from patents and situations similar to the Hines case. Mr. Justice Stone, writing for this court, said:

> "But where the rule is one affecting title to real estate within the State and has been repeatedly determined by decisions of state courts so that it is established as the law of the State, there has been no departure from the rule that the federal courts will follow the decisions of the state courts. *Jackson ex dem St. John* v. *Chew, supra; Green* v. *Neal,* 6 Pet. 291; *Suydam* v. *Williamson,* 24 How. 427; *Walker* v. *The State Harbor Commission,* 17 Wall. 648; *Barrett* v. *Holmes,* 102 U. S. 651. And this is the rule even though the state rule is not approved.

Walker v. *The State Harbor Commissioner, supra; Bucher* v. *Cheshire Railway Co.*, 125 U. S. 555; *Balkam* v. *Woodstock Iron Co.*, 154 U. S. 177. To avoid the uncertainty and injustice which results from 'the discordant element of a substantial right and which is protected in one set of courts and denied in the other, with no superior to decide which is right,' (*Ryine* v. *Insurance Company*, 96 U. S. 627), this court has not hesitated, when there has been a conflict of decision between it and the state courts affecting a rule of property within the state, to overrule its own decisions and to follow the state decisions, once it has become evident that they have established a 'rule of property' as the settled law of the state. *Green* v. *Lessee of Neal*, 6 Pet. 291; *Suydam* v. *Williamson, supra; Fairfield* v. *County of Gallatin*, 100 U. S. 47; *Roberts* v. *Lewis*, 153 U. S. 367, 376. And see *Bauserman* v. *Blunt, supra*, overruling a decision of the Circuit Court antedating a conflicting decision of the state court. We are, therefore, constrained in the present case to accept the view of the state courts as announced by them without inquiring, as an original proposition, into the justice and sufficiency of the rule which we follow" (l. c. 463, 464).

Although there was a state statute and its interpretation involved in the case, it was the decisions of the state court that were held by this court to be determinative of the issues in the Federal Court. At page 362 Mr. Justice Stone said:

> "Both the meaning of statutes of a State and the rules of the unwritten law of a State affecting property within the State are peculiarly questions of local law to be ascertained and established by the state courts" (l. c. 462).

The Kuhn case was a tort action, affecting real property. The case at bar is an action involving a right

and interest in and to real property. There is a real difference between the cases. Conflict between state and Federal decisions is not quite as serious in tort actions, for there, principles of general common law are usually determinative and, by the very nature of the cases, forecast cannot be made with any certainty as to what result might be reached. But conflict between state and Federal law in the same state, where rights and interest to real estate are involved, is especially undesirable because predicability is and has been of paramount consideration. That distinction makes the *Edward Hines Trustees* v. *Martin, supra*, case closer to the case at bar for there is a near connection between an action to remove a cloud on title to real estate and an action to cancel a lease, both of which are different than a tort action even though the tort affects realty.

In *Smith Purifier Co.* v. *McGroarty*, 136 U. S. 237, 10 Sup. Ct. 1017, 34 L. Ed. 346, the action was in *equity* and it was held that a certain mortgage, having been held by the Supreme Court of Ohio to be invalid against general creditors, must likewise be held invalid in the Federal Court. Mr. Justice Gray said:

> "The present case is to be decided by the application of the law of Ohio to the facts stated in this bill and admitted by the demurrer; and the best evidence of that law, as affecting the validity of the mortgages and assignment, is to be found in the decisions of the Supreme Court of Ohio."

In that case, it appears that the mortgage and assignment were made in 1885, and the state decision relied upon was rendered in 1889, or four years *after* the

rights of the parties had accrued, but at a time prior to the action in the Federal Court.

In *Harrell* v. *United Carbon Company*, 52 Fed. (2d) 790, (C. C. A. 5, 1931), it was held that a state decision, made subsequent to an oil and gas lease and after the Federal case was argued in the Circuit Court of Appeals, was binding on the Federal Court, and that partial cancellation should be decreed in accord with the state law thus announced.

3. The Kansas decisions establish the rule of law that there is an implied covenant in an oil and gas lease, to continue with reasonable diligence the work of exploration, development and production after the expiration of the primary term, if during that term oil is found in paying quantities.

In *Alford* v. *Dennis*, 102 Kan. 403, 170 Pac. 1005 (1918), the lease covered two separate tracts of land, one of 220 acres and the other for 716 acres, for 10 years and as much longer as gas or oil may be found in paying quantities. 25 wells were drilled on one tract and none on the others. The primary term had expired. The court said:

> "Since plaintiff's lands are burdened with an oil and gas lease he is entitled to have those lands prospected for oil and gas within a reasonable time. "'*On principle, it would seem that there is such implied covenant in the written instrument. When no time is fixed for the performance of a contract, a reasonable time is implied * * * So, under an oil lease which is silent as to the number of wells to be drilled, there is an implied covenant that the lessee shall reasonably develop the land and reasonably protect the lines*'" (*Harris* v. *Ohio Oil Co.*, 57 Ohio St. 118, 127).

In *Webb* v. *Croft*, 120 Kan. 654, 224 Pac. 1033, the primary term had expired and the court said:

> "Lessees of this kind contemplate exploration and development and not the bottling up of land for speculative or other purposes or the postponement of reasonable development, nor the limiting of development to an extent merely to prevent a declaration of forfeiture. *Although not expressly mentioned in the lease, there is an implied covenant or condition that there shall be reasonable development and such operation as will protect the interests of both the lessor and lessee*" (l. c. 657).

In *McCarney* v. *Freel*, 121 Kan. 189, 246 Pac. 500 (1926), the action was to cancel an oil and gas lease after the expiration of the primary term of 10 years and after one well had been drilled which produced oil in paying quantities and the court said:

> "A lessee may not hold an entire quarter section of land with a single producing well after expiration of term, any more than he may do so before expiration of term. *The implied covenant fairly to exhaust capability of the land to produce mineral, subsists*" (l. c. 190).

Culbertson v. *Cement Company*, 87 Kan. 529, 125 Pac. 81 (1912), states that:

> "Since the number of wells to be drilled on the land was not specified there was an implied obligation on appellants to fully develop the land and put down as many wells as necessary to secure to appellee his proportionate share of the pool of gas" (l. c. 535).

To the same effect see *Mills* v. *Hartz*, 77 Kan. 218, 94 Pac. 142 (1908), and *Howerton* v. *Gas Company*, 81 Kan. 553, 106 Pac. 47 (1910).

4. The obligation to explore and develop requires the lessee fairly to exhaust the capability of land to produce minerals and if the undeveloped portion will not produce minerals in paying quantities, and the lessee would not be justified in drilling more wells, he may not continue to hold by virtue of the provisions in the lease extending the term so long as oil and gas are produced in paying quantities.

The above principle has been established by a line of decisions of the Supreme Court of the State of Kansas.

Mills v. *Hartz*, 77 Kan. 218, 94 Pac. 142 (1908), was an action to cancel a lease giving "exclusive right to dig, bore and mine for gas, petroleum oil and coal," for twenty years, and as much longer as said minerals were produced in paying quantities. Lessor was to receive a royalty per ton, gas for domestic purposes, and $50 per annum for gas obtained from each well. Development was not required within any fixed time. The lessee did no developing and, after 7½ years, this action was brought to cancel the lease for his failure to explore and develop. He contended that the lease did not provide for immediate exploration, but that he had twenty years to explore and develop. In sustaining the ruling of the trial court canceling the lease and the contention that the lease was granted upon an implied condition that the lessee should explore and develop within a reasonable time, the court stated the principles governing mineral leases as follows:

> "We think the court rightly held that, under such a lease, it is the duty of the lessee to make diligent search within a reasonable time. The only consideration moving to the lessor for the right which he gave to the lessee to explore and procure minerals

was the royalty on the coal to be found and the fixed compensation for each well when gas should be found and utilized, together with sufficient gas to supply two stoves in his farmhouse. *If there were no search, nor any product, no possible benefit could come to the lessor for the exclusive rights which had been given to the lessee. It is not easy to infer that the lessor intended to give a valuable right for a nominal consideration, and permit the lessee to retain the right for a period of twenty years without development, when development was the chief purpose in the execution of the lease.* Neither the character of the right given nor the nature of the instrument admits of such an irrational interpretation. The lease contemplates that the lessee shall proceed to dig and bore for gas, oil and coal, and that the lessor shall obtain gas for his farmhouse, not twenty years hence, but as soon as it can reasonably be procured" (l. c. 220).

"*No lease of land for rent, for a return to the landlord out of the land which passes, can be construed to be intended to enable the tenant merely to hold the lease for purposes of speculation without doing and performing what the lease contemplated*" (*Bluestone Coal Co. v. Bell*, 38 W. Va. 297, 18 S. E. 493).

"There is, perhaps, no other business in which prompt performance is so essential to the rights of the parties, or delays so likely to prove injurious —no other class of contracts in which time is so much of the essence.

"*Where the only consideration is prospective royalty to come from exploration and development, failure to explore and develop renders the agreement a mere nudum pactum, and works a forfeiture of the lease,* for it is of the very essence of the contract that work should be done * * * *No such lease should be so construed as to enable the lessee who has paid no consideration to hold it merely for speculative purposes,* without doing what he stipulated to do, and

what was clearly in the contemplation of the lessor when he entered into the agreement" (*Huggins* v. *Daley*, 40 C. C. A. 12, 48 L. R. A. 320).

In *Howerton* v. *Gas Company*, 81 Kan. 553, 106 Pac. 47 (1010), an action to cancel an oil and gas lease, dated November 20, 1902, which provided that a well should be drilled in one year with one-tenth royalty of oil delivered to the lessor, and, if gas was found in paying quantities $50.00 per year for each gas well, a gas well was completed within the year and the production had in commercial quantities sufficient to justify the expense of marketing, but failed to market the gas. The lease was for 10 years and as long thereafter as oil or gas was produced in paying quantities. One well was drilled within a year producing paying gas. There was no further development. In holding that this failure was equivalent to a failure to explore at all, the court stated principles and quoted from authorities, as follows:

> "It is difficult to distinguish in principle between a case like that, where a default consists in a failure to explore at all, and a case like the present one where a well has been drilled and gas found but no effort has been made to utilize or market it. The result to the lessor is the same in either case, except that in the latter he has the satisfaction of knowing that his premises are capable of production (560-1)."
>
> "*It is unreasonable to suppose that it was understood that the completion of one well, without operation or production, except to furnish gas for the plaintiff's home, was all that the lessee was bound to do for more than four years*, in which time, it might be fairly presumed, many wells would be drilled in nearby territory and gas marketed therefrom, as in fact actually occurred.

"'Generally all leases of land for the exploration and development of minerals are executed by the lessor in the hope and upon the condition, either express or implied, that the land shall be developed for minerals; and it *would be unjust and unreasonable, and contravene the nature and spirit of the lease, to allow the lessee to continue to hold under it any considerable length of time without making any effort at all to develop it according to the express or implied purpose of the lease;* and, in general, while equity abhors a forfeiture, yet, when such a forfeiture works equity, and is essential to public and private interests in the development of minerals in land, the landowner, as well as the public, will be protected from the laches of the lessee and the forfeiture of the lease allowed, where such forfeiture does not contravene plain and unambiguous stipulations in the lease. This principle will be more readily enforced and applied by the court as to gas-and-oil cases because of the peculiar nature of those minerals and the danger of entire loss to the lessor of oil or gas in his lands by reason of well drilling on adjacent lands'" (11 L. R. A. (N. S.) 417; l. c. 558, 559).

"'In grants of the character in question, the title is inchoate, and for the purpose of exploration only, until oil or gas is found in quantities warranting operation; and while the courts manifest a disposition to protect the grantee at this stage by treating his interest as no longer postponed to the happening of a condition precedent, yet it is *thoroughly settled that he can not omit to develop the property and hold the grant for speculative purposes purely*'" (*Gadbury* v. *Ohio etc. Gas Co.*, 162 Ind. 9, 14).

"'It would be unjust and unreasonable, and contravene the nature and spirit of the lease, to allow the lessee to continue to hold his term a considerable length of time, without making any effort at all to mine for gold or other metals.' Such a construc-

tion of the rights of the parties would enable him to prevent the lessor from getting his tolls under the express covenant to pay the same, and deprive him of all opportunity to work the mine himself or permit others to do so. The law does not tolerate such practical absurdity, nor will it permit the possibility of such injustice'" (*Conrad* v. *Morehead*, 89 N. C. 31, 35).

"* * * The *testing provided for in such case was of the very essence of the contract, not only with respect to the time within which it was to be done, but as to the thoroughness and certainty with which the mineral value of the lands should be ascertained.* * * * The "testing" provided for was manifestly a condition upon which the lease depended. If such test showed no minerals, then the contract was at an end; if it, on the other hand, showed the presence of valuable mines then the lessees were bound to operate them in good faith for the joint profit of themselves and the owners of the fee. * * *" (*Petroleum Company* v. *Coal, Coke, and Manufacturing Company*, 89 Tenn. 381, 388, 389)."

The court canceled this lease, but, in subsequent decision, *Howerton* v. *Gas Company*, 82 Kan. 367, 108 Pac. 813 (1910), reversed the decree of cancellation and provided that the lessor should prove its damages at a trial, but that if it should be ascertained that such rule could not be applied, an alternative decree should be entered requiring the lessee to proceed, within a reasonable time, fixed by the court, to drill wells and protect the land leased and, upon his failing to do so, that the lease be canceled. In this case, the court approved the principles hereinabove quoted from the first opinion.

It will be contended that the original opinion in this case was withdrawn on rehearing. Not so! It was stated

that: "The court is satisfied with the former opinion, except in one particular. It was held that there was an adequate remedy in damages for the default of the defendant."

Syllabus 1, of the opinion in this case, at 82 Kan. 367, expressly states that:

> "Adhering to the decision on a former hearing (*Howerton* v. *Gas Co.*, 81 Kan. 553) that the contract contemplated that other wells should be drilled with reasonable diligence to utilize this lease * * *"

and said authority has been cited with approval in *Day* v. *Kansas City Pipe Line Co.*, 87 Kan. 617, 622, 125 Pac. 43; and in *Alford* v. *Dennis*, 102 Kan. 403, 406, 170 Pac. 1005. It is true that the court required proof of damages, but stated that:

> "This is not a case where royalty payments in a share of the product are provided for but is an agreement to pay $50.00 per annum for each gas well."

Damages therefore were definitely ascertainable, a situation not present in the instant case, which will be pointed out more specifically hereinafter.

In *Culbertson* v. *Cement Company*, 87 Kan. 529, 125 Pac. 81 (1912), although the facts are different, the following principle announced is applicable:

> "Since the number of wells to be drilled on the land was not specified there was an *implied obligation* on appellants *to fully develop the land and put down as many wells as were necessary to secure to appellee his proportionate share of the pool of gas*" (l. c. 535).

In this case the court cited with approval from *Kleppner* v. *Lemon*, 176 Pa. St. 502, where an oil and gas lease

providing for one-eighth royalty and $500.00 per annum for each gas well, contained no distinct covenant for putting down wells, except the first one, as follows:

> "But in a lease for oil purposes, a stipulation that other wells shall be put down where the land is shown to be valuable for oil by the production of the first or test well, is not indispensable. * * * *it is an implied condition of every lease of land for the production of oil therefrom that when the existence of oil in paying quantities is made apparent the lessee shall put down so many wells as may be reasonably necessary to secure the oil for the common advantage of both lessor and lessee.* * * * Whatever ordinary knowledge and care would dictate as the proper thing to be done for the interest of both lessor and lessee under any given circumstances is that which the law requires to be done as an implied stipulation of the contract."

In *Day v. Kansas City Pipe Line Company*, 87 Kan. 617, 125 Pac. 43 (1912), a judgment was entered canceling a gas lease for failure to develop properly. The lease required four wells to be drilled within six months and to continue drilling as long as paying wells were found or royalties were paid. Four wells were drilled on one 80 acre tract and nothing further was done for a period of four years. After the suit was filed four additional wells were drilled on another 80 acres, producing oil in paying quantities, leaving 440 acres undeveloped. Although the primary term had not expired, an action was brought to cancel the lease, and the decree canceling the same as to 440 acres, upon which no wells had been drilled, was affirmed. The case is distinguishable in that there was an express covenant "to continue drill-

ing as long as paying wells are found or royalties paid." The following statements are applicable:

> "Appellant says that the lease does not expressly provide how many wells should be sunk on the land; that in the development two dry holes were drilled, and that it had reason to believe that further drilling would be attended with great risk and many dry holes be found, and as each costs a large sum of money it was not required to run that risk. It also says that the number of wells which shall be sunk on land is not to be determined by the landowners, nor yet by the courts, but is to be determined by the operator so long as he acts in good faith" (l. c. 622).
>
> "It was the manifest intention that the tract leased was to be developed for the mutual benefit of both parties, and the only substantial benefit to be derived by appellees was the royalties to be paid from drilled and operated wells. It was not enough that exploration should be made and gas found and allowed to remain in place on the land. It was not enough that four wells should be drilled within six months, or any limited number, on a part of the tract, but it was specifically required that drilling should continue with reasonable diligence so long as paying wells could be found. The appellant was, of course, not required to develop land that had been tested and found to be unprofitable for operation, but *if paying wells could not be found on the land or any part of it there is no reason why appellees' title should be longer clouded with a barren encumbrance nor any reason why appellant should resist a cancellation*" (l. c. 622-3).

In *Alford* v. *Dennis*, 102 Kan. 403, 170 Pac. 1005 (1918), the lessor executed a lease in 1902 covering two tracts of land, one of 220 acres two miles distant from one of 716 acres for 10 years and as much longer as gas

or oil was produced in paying quantities. Drilling was to commence in six months and three wells were to be drilled by January, 1924. There were twenty-five producing wells on the larger tract, but no exploration was made of the smaller. The primary term had expired. The Supreme Court stated that the plaintiff asks the court to cancel the contract and to decree a forfeiture of it, for the default of one of its implied covenants. Then, citing its earlier decisions, the court said:

> "Unless the plaintiff's tract was to be developed some time there was no reason to include it in the lease, and as it stands it is of no value to defendants. Unless the defendants had a *bona fide* intention to prospect and develop this tract they had no proper purpose in leasing it, and to cancel the lease will do them no injury. While equity abhors forfeiture it likewise abhors injustice" (l. c. 406).

Thereupon, the court directed that the demurrer be overruled, issues be joined, and the facts determined to allow plaintiff damages if they could be definitely ascertained and in the alternative that defendants be required to proceed in good faith to prospect and develop plaintiff's land within a reasonable time to be fixed by the court, and on failure so to do that the lease be cancelled (407).

In *Webb* v. *Croft*, 120 Kan. 654; 224 Pac. 1033, an action to cancel an oil and gas lease for a term of five years and as long as oil and gas or either of them was produced in paying quantities, the consideration was $580.00 cash, one-eighth of the oil and $200.00 for gas produced from each well. A well was to be completed

in 12 months or $580.00 per year paid as delayed rental. One well was completed the day before the expiration of the lease, delayed rentals were paid and there was nothing due the lessor on the lease when the action was begun (655). The lease covered 580 acres with one producing well thereon and the closest developments to the lease were two wells, each three-quarters of a mile away. The defendants claimed that greater development was not justified as there was no market for the gas in the vicinity except such as would meet the needs of the residents of the City of Moline, that it was necessary for them to hold these tracts as a reserve and that it was impracticable and against public policy to drill more wells and produce gas in any greater quantities than could be used under the franchise of the City of Moline. The trial court found that the lease had not been sufficiently developed and entered a decree requiring certain additional drilling operations and payments of money as delayed rentals, retaining jurisdiction to see that the decree was complied with. In response to the defendants' contention that they had kept the lease alive by drilling one well during the lease period, and had paid the accrued rentals and royalties and that the court was not warranted in requiring further development, the Supreme Court said:

> "*Leases of this kind contemplate exploration and development and not the bottling up of land for speculative or other purposes or the postponement of reasonable development, nor yet the limiting of development to an extent merely to prevent a declaration of forfeiture.* Although not expressly mentioned in the lease, there is an implied covenant or

condition that there shall be reasonable development and such operation as will protect the interests of both the lessor and lessee. (*Howerton* v. *Gas Co.*, 81 Kan. 553, 106 Pac. 47; *id.*, 82 Kan. 367, 108 Pac. 813; *Alford* v. *Dennis*, 102 Kan. 403, 170 Pac. 1005; *Harris* v. *Ohio Oil Co.*, 57 Ohio St. 118.) The lease is silent as to the number of wells that shall be drilled on the land, and in such a case there is an implication that there shall be reasonable development of the land by drilling such number of wells as an ordinary prudent man would do under the circumstances, taking into consideration the results of the development and whether or not there was sufficient production to warrant the continuance of exploration and drilling" (l. c. 657).

"We think the court rightly concluded that the land of defendants has not been sufficiently developed. It would be grossly inequitable to hold a tract of 580 acres with no more development than has already been made. Plaintiff was entitled to some remedy for the failure to develop it, and we think it was competent for the court, instead of decreeing a cancellation of the lease, to give the defendants an opportunity to make reasonable development of the land pursuant to their implied covenants, as has already been determined in *Alford* v. *Dennis, supra*" (l. c. 658).

It is well to note that the court ordered additional development on the facts above stated with no showing whatever as to whether the lease was in a proven field or whether production was had on adjacent land or any facts of that character.

McCarney v. *Freel*, 121 Kan. 189, 246 Pac. 500 (1926), was an action to cancel an oil and gas lease dated June 15, 1912, for ten years and as much longer as oil and gas could be produced in paying quantities.

It embraced a quarter section of land. In October, 1912, a well was drilled which produced and still was producing oil in paying quantities. In November, 1917, a dry hole was drilled. No further effort was made to develop, although there were numbers of producing wells drilled and in operation on surrounding land. In affirming the decree of cancelation, the court said:

> "Plaintiff's evidence warranted the inference that defendants have not reasonably developed her land, and have no present intention to do so: * * * *The testimony in support of the defense was, a man would not be justified in drilling any more wells on plaintiff's land.* The court canceled the lease, except as to a tract having a radius of 200 feet surrounding the producing well.
>
> "The judgment was correct, whether based on plaintiff's or on defendants' theory of the case. *A lessee may not hold an entire quarter section of land with a single producing well after expiration of term, any more than he may do so before expiration of term. The implied covenant fairly to exhaust capability of the land to produce mineral, subsists. If the undeveloped portion of the land will not produce mineral in paying quantities, and the lessee would not be justified in drilling more wells, he may not continue to hold by virtue of a provision in the lease extending the term so long as oil or gas may be produced in paying quantities*" (l. c. 190).

The foregoing decisions constitute an unbroken line of precedent establishing the law of implied covenant to develop and explore an oil and gas lease in the State of Kansas, support the findings of the trial court and compel a result different from that arrived at by the Circuit Court of Appeals. The court followed the rule that the measure of diligence is what, under the circumstances,

an ordinary prudent operator would do, having regard to the interest of both lessor and lessee, following its prior opinion in *Denker* v. *Mid-Continent Petr. Corp.* (C. C. A. 10, 56 F. (2d) 725), involving the cancelation of an oil and gas lease on land in Oklahoma. This was not the law in Kansas either before or after the execution of the Sauder lease. The Mills, Howerton, Culbertson, and Day cases (*supra*) established the principle contended for by petitioners prior to 1912. Immediately after the lease was made there came *Alford* v. *Dennis*, *Webb* v. *Croft*, and *McCarney* v. *Freel* (*supra*), in rapid succession and all without any intimation by the Kansas Supreme Court that there was even a scintilla of conflict with the earlier cases. They establish that there has been no change in the rule of property involved applicable to the instant case, and the decisions of the Kansas court adhere to the same general test first announced in *Brewster* v. *Lanyon Zinc Co.* (C. C. A. 8), 140 Fed. 801, but the Kansas court places more emphasis on the phrase "having due regard for the interests of the lessor" than does the Federal court.

To state that in the foregoing cases there was no expert testimony that a reasonably prudent operator would ~~not~~ have drilled additional wells on the Sauder lease; or no evidence that had additional wells been drilled oil or gas would ~~not~~ have been discovered in paying quantities; or that the court assumed that oil could be so produced in paying quantities; or that a statement by the court that unless the land were to be developed some time there was no reason to have included it in the lease was *obiter dictum;* or that an opin-

ion is short and doesn't cite any authorities; do not shake the principles enumerated. The rationale is the same whether one well has been drilled as required by the lease or none have been drilled. In determining whether or not there has been an absence of diligence, the Kansas decisions put a real meaning and greater emphasis on the phrase, "having due regard for the interests of the lessor" than other jurisdictions, and it will be shown hereinafter at subdivision B-1 of this brief, pages 58-65, that the absence of diligence has been certain and substantial under the facts and circumstances of this case.

On the other hand, if we do not construe correctly the Kansas decisions, the question was at least an open one. Under those circumstances, the rights of the parties should be governed by the later decisions of the Kansas courts rather than by the still later decisions of the Federal court. As Circuit Judge McDermott stated:

> "Why should the rights of these parties be determined by our decision in the *Denker* case, decided in 1932 in ~~1933~~, instead of the decision of the state Supreme Court in the *McCarney* case decided in 1926?" (R. 96).

The respondent came voluntarily to Kansas, and acquired this lease. It is charged with knowledge that the decisions of the Kansas Supreme Court prior to that time emphasized the fact that the prior consideration moving to a lessor was the development of his property and that it would place an emphasis upon the respondent's obligation to "pay heed to the interest of the lessor." To permit it to have applied a rule, Federal or

otherwise, is to permit it to crawl out from under an obligation which it knew, or should have known that it had, and in consideration of which it acquired the right to develop the land of these petitioners. A Kansas resident or company would not have acquired the rights for which it contends. Why should a non-resident acquire rights in Kansas property superior to those which a Kansas citizen would acquire under similar circumstances?

The majority of the Circuit Court took the position that *Webb* v. *Croft, supra,* was Kansas authority in support of the principle applied by it from *Denker* v. *Mid-Continent Petr. Co., supra.* Although it is true that in the opinon in that case reasonable development was referred to as "drilling such number of wells as an ordinarily prudent operator would do under the circumstances, taking into consideration the results of the development and whether or not there was sufficient production to warrant the continuance of exploration and drilling," yet in applying that test as the measure, the court still adhered to the rule that there must be development, and held that it was grossly inequitable to hold a tract of 580 acres with but one producing well thereon. Applying the principle of what an operator of ordinary prudence would do, with due regard for the interests of the lessor, the Kansas decisions hereinbefore set out will not permit the lessee to hold an undeveloped tract for speculation, without any intention to develop it, gamble on the future at the expense of his lessor, and use geologic science to condemn the lease as a justification for

his failure to develop it diligently as being worthless and yet refuse to back up that scientific information by surrendering the lease and letting someone else try it. Under the principles of the Kansas cases, such conduct does not square with "due regard for the interests of the lessor" and constitutes a breach of the implied obligation to explore and develop.

5. Sound reason dictates the necessity of following the rule of property established by state decisions.

Swift v. *Tyson* expressly excepted from the operation of its doctrine state decisions affecting rights to things having a permanent location in the state, cases involving rights and interest in real property, and questions of local law. The extensions of that case have been many, but to extend it under the authority of the Kuhn case to the case at bar works a confusion and doubt as to just what rights the parties may have, instead of securing uniform rules of law.

In place of safeguarding a non-resident from discrimination in matters of title to real property, the decision of the Circuit Court of Appeals in this case subjects the resident to a discrimination. In *Smith Purifier Company* v. *McGroarty, supra,* the court said:

> "It would be an extraordinary result, if the courts of the United States, in exercising the jurisdiction conferred upon them with a view to secure the rights of citizens residing in different States, should hold such a conveyance to be valid against citizens of other States as the Supreme Court of Ohio holds to be void as against its own citizens" (l. c. 241).

In *United States* v. *Cargill*, 258 Fed. 458, the court remarked:

> "For this court to refuse to follow the decisions of the Supreme Court of Arkansas would result in granting to non-citizens of the state, who can maintain action in the national courts, benefits not possessed by citizens of the state, and relief denied to the latter. This should be avoided, if at all possible" (l. c. 466).

As pointed out by Judge McDermott, dissenting in the case at bar (R. 98, 103-4), the effect of the decision in this case gives to a non-resident lessee greater rights than a resident lessee possesses under an oil and gas lease within the State of Kansas. If the lessors had leased the premises to a resident lessee, there could be no question in this case but that the lease should have been canceled. The decision of the trial court was according to Kansas law. A non-resident should have no just cause of complaint if his rights are measured by the same law as that of residents when he comes voluntarily into the state and acquires an interest in or a claim to real estate.

As it has often been pointed out, there is no reason to believe that concurrent jurisdiction was conferred upon the Federal courts in case of diversity of citizenship to make it possible for non-resident parties to secure the application of a different rule than that available to a resident. It was the conception of Chief Justice Marshall that jurisdiction based on diversity of citizenship was to protect the non-resident suitor from local inequality with residents in the application of law to his particular case. *Bank of U. S.* v. *Deveaux*, 5 Cranch 61,

87. It was not for the purpose of securing to the non-resident a different set of rights or rules than those possessed by the resident, but to safeguard against an unfair and an antagonistic application of the same rules and rights which the resident had.

Mr. Justice Holmes has aptly stated the case for Federal courts following state decisions in questions of title and interest to real estate:

> "The title to real estate in general depends upon the statutes and decisions of the State within which it lies. I think it a thing to be regretted if, while in the great mass of cases the state courts finally determine who is the owner of land, how much he owns and what he conveys by his deed, the courts of the United States, when by accident and exception the same question comes before them, do not follow what for all ordinary purposes is the law." *Kuhn* v. *Fairmont Coal Co.*, 215 U. S. 349, at 370.

In this connection, Judge Caldwell, in *Hartford F. Insurance Company* v. *Chicago, M. & St. P. R. Co.*, 70 Fed. 201, states "As a result of these diverse rules of decision, each party to a suit engages in an unseemly struggle to get into that jurisdiction whose rules of decision are believed to be most favorable to his side of the case."

It has also been pointed out that, if a state should enact a rule of general law into statute, it would be the duty of the Federal court to apply that statute. Because a state law is announced by a decision of court, it should have no less effect than when it is announced by statute. See dissenting opinion of Mr. Justice Holmes, *Black & White Taxicab Co.* v. *Brown & Yellow Taxicab Co.*, 276 U. S. 518, 48 Sup. Ct. 404, 72 L. Ed. 681.

Furthermore the result of the wide extension of the doctrine and its uncertainty has led to serious proposals to abolish Federal jurisdiction based on diversity of citizenship (15 A. B. A. Journal 401), and has led to suggested legislation to require Federal courts to follow state decisions in all law except Federal questions (*Senate Resolution* 4333, 69th Congress, 1st Session, *U. S. Daily,* May 4, 1928, p. 585; 69 *Congressional Record* 8439 *et seq.*).

The result of the decision in this case by the Circuit Court of Appeals causes extreme embarrassment in the field of real property rights, title and interest where predictability is especially important. It is impossible to determine one's rights until it is determined in which court the action is to be brought. In addition, predictability is further reduced because of the difficulty of forecasting with any degree of certainty whether the Federal court will regard the precise question one of local or general law. *Kuhn* v. *Fairmont Coal Company, supra; Smith Purifier Company* v. *McGroarty, supra; Edward Hines Trustees* v. *Martin, supra.*

In thus departing from the accepted and usual course of proceedings the Circuit Court has created a conflict of authority in the Circuit Courts. The 8th Circuit, in *Thurlow* v. *Waite-Phillips Oil Co.* (C. C. A. 8), 22 F. (2d) 781, an action to cancel an oil and gas lease as a cloud on the title, held that the matter related to title to real estate, and the Federal Court was bound by the decisions of the Supreme Court of Kansas, even though in the opinion of the court, they have produced a patent and burdensome injustice.

And in *Harrell* v. *United Carbon Co., supra,* an action to cancel an oil and gas lease on Louisiana land, because no wells had been commenced within a five year period, the Circuit Court held that it was bound by the decision of the Supreme Court of Louisiana, which definitely established a rule of property in Louisiana, even though the decision was rendered after the case was argued in the Circuit Court.

6. That the relief sought is in equity does not take from the Kansas decisions their binding effect.

That the relief sought was in equity does not relieve from the binding effect of property rights established by Kansas law. The cases previously cited in Sec. A-2 of this brief establish that when the local law relates to acquisition, rights to, interest in, or liens upon or affecting property located within the state, even though dependent upon the unwritten law of the state, as announced by state court decisions, those decisions are to be followed in a Federal Court sitting in that state.

Local rules of property have the same effect in a court of equity as in a court of law. Many of the cases cited in the foregoing sections of this brief were suits at equity where local rules of property were recognized as binding.

Edward Hines Trustees v. *Martin,* 268 U. S. 458, was an equitable action to remove a cloud on title; *Smith Purifier Co.* v. *McGroarty,* 136 U. S. 237, arose on a bill in equity; *Abraham* v. *Casey,* 179 U. S. 210, was a case in equity; *East Central Eureka Company* v. *Central Eureka Company,* 204 U. S. 266, 27 Sup. Ct. 258, 51 L.

Ed. 476, was an equitable action to quiet title; *Thurlow* v. *Waite-Phillips Oil Co.*, (C. C. A. 8) 22 F. (2d) 781, arose on an equitable bill praying removal of cloud on title and seeking injunctive relief; *Harrell* v. *United Carbon Co.*, (C. C. A. 5) 52 F. (2d) 971 (1931) was an equitable action for partial cancellation of an oil and gas lease for failure to develop within the primary term.

There are numerous other cases in equity following local rules as to substantive rights in or affecting realty or property. *Brine* v. *Insurance Co.*, 96 U. S. 627.

Lancaster v. *Oil Company*, 241 U. S. 551, was an equitable action holding that whether the interest acquired under an oil and gas lease was the subject of ejectment was to be determined in accord with state decisions.

See also: Hughes Fed. Practice, Vol. 7, Sec. 4129, wherein it is said:

> "A rule of property is as applicable in cases on the equity side as in cases on the law side."
> Williams Federal Procedure, 2nd Ed. Chap. XIV, Sec. 8, page 371.

At equity, as at law, the difficulty arises in distinguishing between matters of general equity jurisprudence and strictly local rules of property. In Sections A-1 and A-2 of this brief, it is shown that the matter under consideration is one of a local nature, and that the state decisions constitute rules of property.

A further distinction in equity cases is to be noted. The Federal equity courts are not bound under the conformity act, Title 28, U. S. C. A., Sec. 724, to apply local

rules in matters of procedure. However, as revealed by authorities cited above, in matters of substantial equitable rights, the existence of which depends on local rules of property, local law is decisive in the Federal equity court. Where there exists a substantive right created by local law, the Federal courts are at liberty to determine the *remedy* and whether the right is one of equity or law in the Federal jurisdiction. If it is a right within the Federal equity jurisdiction, the procedure and remedy cannot be controlled by state statutes or decisions. See *Brine* v. *Insurance Co., supra; Watts* v. *Camors,* 115 U. S. 353.

Guffey v. *Smith,* 237 U. S. 101, illustrates the difference between substantive rights and procedural remedy. In that case an action at equity was brought by the holders of an oil and gas lease to enjoin operations under a second oil and gas lease, and to obtain an accounting of oil and gas produced from operations already had, under the second lease. It was said, by Mr. Justice Vandevanter, l. c. 112:

> "It is settled by the decisions of the Supreme Court of Illinois that an oil and gas lease like that of the complainants passes to the lessee, his heirs and assigns, a present vested right—'a freehold interest'—in the premises, that this interest is taxable as real property, and that the clause giving the lessee an option to surrender the lease at any time is valid, does not create a tenancy at will or give the lessor an option to compel a surrender, and does not make the lease void as wanting in mutuality (cases cited omitted). These decisions constitute rules of property and must be accepted and applied in passing upon the complainants' rights."

While the Supreme Court of Illinois fully sustained the validity of such leases and the right to maintain a suit on such leases in courts of law, it was held by the state court that the presence of a clause in the lease giving the lessee the option to surrender it at any time prevented the lessee from enforcing certain provisions of the lease in equity, because it lacked mutuality. In the Federal court such a degree of mutuality of remedy is not a requisite of equity procedure, and it has been frequently held that Federal equity courts are not controlled by a local rule as to enforceability of contracts lacking mutuality. *Union Bag Corp.* v. *Bischoff*, 255 Fed. 187.

Therefore, it was stated by Mr. Justice Vandevanter for this court:

> "By the legislation of Congress and repeated decisions of this court it has long been settled that the *remedies* afforded and *modes of proceeding* pursued in the Federal courts, sitting as courts of equity, are not determined by local laws or rules of decision, but by general principles, rules and usages of equity having uniform operation in those courts wherever sitting."

Thus in that case this court recognized and held binding the validity of the substantive rights under the lease as announced by the local law, but applied the Federal court's own equitable procedural remedy, which did not exist under the state law.

It is submitted from the above authorities that as to substantive rights, as rules of property not constituting matters of general law, Federal equity courts are bound by state law, although the particular remedy

to be applied is within the determination of the Federal court.

The implied covenant to explore and develop the leased premises is a substantive right in the Kansas law,

McCarney v. *Freel*, 121 K. 189,
Alford v. *Dennis*, 102 K. 403,
Brewster v. *Lanyon Zinc Co.*, 140 F. 801,

and the ordinary remedy in the Federal equity court for breaching that covenant is cancellation.

Brewster v. *Zinc Co.*, *supra*.
Harrell v. *United Carbon Co.*, *supra*.

7. There is certain and substantial evidence that respondent breached its obligations to explore and develop with reasonable diligence.

The discussion in support of this point is set out in subdivision B-1, pp. 58-65 of this brief, and is inserted here by reference to avoid repetition.

8. Plaintiff had no adequate remedy at law.

In opposition to the petition for a writ of certiorari, respondent contended that plaintiff must prove that his damages at law are not susceptible of measurement as a pre-requisite to the right to cancel the lease. This was on authority of *Howerton* v. *Gas Co.*, *supra*. That contention was raised for the first time in this court. In that case the court did hold that the plaintiffs had failed to show, as they were required to do in order to attain equitable relief, that damages would not accord adequate remedy. But in that case no royalties were involved, but only an agreement to pay $50.00 per annum for each gas well. The court said:

> "The measure of damages * * * is the sum the plaintiffs have lost or may lose by the failure of the defendant to complete the number of producing wells necessary to develop the resources of the leased land, and to protect its lines. When the plaintiffs shall have received $50.00 per year for each well from the time it should have been drilled, they will have received the full compensation agreed upon in the lease. Under the terms of the lease they have no share in the product of the wells, no concern as to the disposition which shall be made of that product, and the rules to be applied where the lessor is given a royalty are not entirely applicable here" (l. c. 370).

That is far different from the instant case where the sole consideration of the lessor depends on production and the amount; where drainage will seriously impair his interest; where the intention not to develop is apparently a continuing one; where the amount which might be produced is most important, yet is not susceptible of certain ascertainment; and where cancelation is more consonant with right, justice and morality than to withhold equitable relief.

Damages were mentioned in *Alford* v. *Dennis, supra.* That case went up on demurrer. The court announced the principles with reference to the duty to explore, directed the overruling of the demurrer, and the inquiry into the facts, to allow damages if they could be definitely ascertained and in the alternative to require the lessee to explore upon failure to cancel the lease. In *Webb* v. *Croft, supra,* the court said:

> "There is a suggestion that damages was a proper remedy for plaintiff rather than a decree for development. An action for damages, however, is not ade-

> quate nor at all practicable, since there is no way to ascertain the extent of damages sustained, but it is within the power of a court of equity to require proper development within reasonable times, and if there is a failure of compliance by defendant, plaintiff would be entitled to absolute forfeiture'' (l. c. 658).

The right to equitable relief has been upheld in an action to forfeit and cancel a recorded contract for the sale of land (*Westbrook* v. *Joseph Schmaus,* 51 Kan. 558, 33 Pac. 306), and in the cancelation of oil and gas leases (*Mills* v. *Hartz, supra; Day* v. *Kansas City Pipe Line Co., supra; Webb* v. *Croft, supra;* and *McCarney* v. *Freel, supra; Brewster* v. *Lanyon Zinc Co., supra*). In *Preston* v. *Oil Co.,* 108 Kan. 810, 196 Pac. 1098, an action to cancel an oil and gas lease, defendant contended that plaintiff did not allege or prove that he was without remedy at law. The court said:

> 'An adequate remedy at law which will preclude proceedings in equity must be equally complete, efficient, practical and prompt with the remedy in equity'' (l. c. 812).

And that facts will confer jurisdiction without reference to the pleadings, saying:

> ''The petition in this case alleged that the lease was executed to secure the full development of the land for oil and that the grantee and its successors had failed to comply with the purpose of the lease and the defendants were not making any effort to develop it but withholding it for speculative purposes only * * * It would seem self-evident that under the circumstances thus set forth, mere damages could not well form the only object for which the plaintiff could seek relief from the courts in this state * * *'' (l. c. 813).

Under these authorities and the facts of this case, plaintiff had no adequate remedy at law and was entitled to proceed in equity.

B. The Circuit Court of Appeals Erred in Holding That There Was no Breach of the Implied Covenant to Explore and Develop.

1. Even though the rule contended for by the respondent be adopted, there is certain and substantial evidence that it has breached its implied covenant to explore and develop with reasonable diligence.

The rule adopted by the majority opinion below, with respect to development was that "there is an implied obligation on the part of a lessee to drill such wells as under the circumstances an operator of ordinary prudence, *having regard for the interests of both the lessor and lessee, would drill*" (R. 88-9). It further held the respondent had not breached any covenant, express or implied and that the trial court did not find that it had breached its implied obligation (R. 89); and that the trial court was requiring the company to do what a prudent operator would not do. The court does say that if there were "slight indication that the undeveloped portion contains oil or gas in paying quantities, regard for the interest of the lessee, as well as the lessor, would require further development." But under the facts as they existed, held it was not required.

What are the facts and what do we mean by the phrase "having regard for the interest of the lessor?"

Petitioners have 360 acres of land; they turn it over to respondent, give him right to explore for oil

and gas for 10 years or as long as produced in paying quantities, on a royalty basis; give possession for the purpose, the right to pay off encumbrances on the land and have a lien therefor; and make it binding on the heirs, assigns and successors. The express covenant required it to drill one well within one year. Respondent drills two wells way down in the Southwest corner, offsets to wells in practically a virgin field—they produce oil in paying quantities and have continued to do so for 10 years.

Wells are drilled on land adjacent to and surrounding, year after year, a great proportion of which are producers—to the Northeast, East, Southeast, South, Southwest and West—76 producing wells on adjacent land, and but 6 dry holes and 2 abandoned (Exh. 1-66-A). In addition, there are 84 producing wells on land immediately surrounding, all of which produce from the Mississippi lime (Exh. E-72-A), a formation which underlies the lease in question. The respondent owns the Southwest Quarter of Section 15, lying adjacent on the East, on which it drills 10 wells, gets 10 producers, but has to abandon one; also owns the Northwest Quarter of Sec. 22, lying adjacent on the Southeast, on which it drills 12 wells and gets 12 producers; also the North Half of Sec. 21, lying immediately adjacent in the South, on which it drills 11 wells, gets 10 producers, one of which has to be abandoned.

In the meantime it takes $72,694.18 off the lease as its share, which pays back its entire investment, all operating expenses, etc., and $26,229.21, additional profit in 10 years' time. In the meantime respondent does

nothing to further develop the 360 acres and leaves lessee sitting. When asked to develop, its officers say it has no intention to do so unless some one else takes the gamble and proves that it should. In the meantime, for 17 years, lessor sits quietly by with a cloud on his title, the existence of oil an established fact, in a recognized oil field, and watches production develop all around him and faces that continuous condition—the only tract in a trend—Northeast and Southeast—for five miles, without development.

The Circuit Court says an ordinarily prudent man wouldn't drill, that a reasonably diligent man having regard for the interest of the lessor and himself would continue to sit by.

There isn't any question as to what ordinary horse-sense of a layman would dictate. But respondent says the geologic inference is unfavorable—and that the indications are that there is no Bartlesville sand under the lease, and a lime foundation under the Sauder lease is from 570-610 feet below sea level, and wells encountered at greater depth than 570 feet in this vicinity are dry holes. Sure there are dry holes between 590-610 feet, but there are also dry holes as high as 564 feet. But between 570-610 feet there are 23 producing wells on the East half of Section 20, West half of Sec. 21, in adjoining sections—9 of which are higher than 570 feet; and 20 producers in the same range in Sec. 29 adjoining it on the Northeast and 17 in a field adjoining on the Northeast.

Respondent's officers testify that three dry holes around the Sauder lease, one on the North and two on

the West of the land indicate the absence of oil. Although they were practical men they gave opinions as to their theories only—admitting they might be wrong, would not say they could tell where oil could be found, and stated the only way to determine with certainty was by drilling wells. One of them testified that he did not think there was any drainage.

Although Theta No. 2 is dry to the north, there is production to it close on the East, Northeast, North, and Northwest. Although Theta No. 21, is dry (SW ¼, Sec. 10), there are four producers in a line straight South and around it. Although Gillespie No. 4 (Northeast ¼, Sec. 20) is dry, there are wells North, Northwest and Northeast around it; although Florence No. 2 (SW ¼, Sec. 16) is dry, there is production South, Southeast, Southwest and West, and Northwest; although Syndicate No. 1 (NW ¼, Sec. 16) is dry, there is no development close enough to it to make it of any significance. Suppose Florence No. 1 had been drilled first. On respondent's theory there would never have been any production in the Southwest Quarter of the Sauder lease, and in the territory around it. The truth is that the Sauder land is neither proved nor condemned. No one will ever know whether the interests of the lessor and lessee are being protected until wells are sunk and the anxiety of respondent to keep the well corroborates that fact.

The respondent never has developed or explored at all. The lease contemplated the drilling of one well within a year for the purpose of finding out whether there were oil or gas. The lessee was willing to spend

his money for that purpose—just to find out. It has never done that. Production was brought in across the Sauder line and respondent drilled two offset wells on a sure thing and to perform its implied covenant to protect the lines. It has never yet performed its implied covenant to explore within the contemplation of the parties.

The following shows the respondent's return from the two wells:

Respondent's share from 2 wells to 12-31-31		$72,694.18
Total cost of drilling, equipping and operating	$46,464.97	
Cost of drilling and equipping 2 wells	32,000.00	
Cost of operation		14,464.97
Gross profit from operation Nov. 7, 1921) to Jan. 12, 1922) 12-31-31.		58,229.21
Gross profit from operation per year		5,822.92

Amount invested—$32,000.00. Rate return per yr. 18.2%

Depreciate the investment over 10 years and it will have earned them approximately 23% of the investment over that period—pay them back all the investment and leave them with clear income of whatever it pays from now on—depending on production and price of oil —now about $1,500.00 a year.

Out of this maze of testimony—opinion evidence conflicting with the physical facts, the court found:

With reference to drainage—That there was no absolute way of determining the question of drainage except by drilling tests, and that there is some probability that drainage is being done to this leasehold by draining on adjoining properties.

With reference to the possibility of oil—The court is unable to determine the facts but finds that no positive evidence having been introduced by either party as to this contention of plaintiffs, that nothing but exploration and positive test by drilling upon said land can settle the controversy as to whether oil and gas in paying quantities can be found upon said land. Neither the defendant nor any of its predecessors in title have drilled any well upon the east half of Section Sixteen (16) but no dry well has been drilled on any of the property covered by said lease (R. 35).

On the question of intention to explore—No effort has been made by the defendant since said letters toward exploration or development by the drilling of wells or otherwise and the evidence in this case shows that the defendant and its officers and employees have no present intention of further exploring or developing said lease and no intention ever to further develop said lease unless and until further developments in the immediate vicinity thereof might convince said defendant and its officers and agents that it would pay the defendant to further explore or develop said lease. Evidence of the defendant tends to show that the land covered by the lease in the instant case is worthless for oil drilling purposes (R. 36).

The Circuit Court says that the trial court did not find that the implied covenant had been breached and that there would be no evidence to support such a finding. The trial court found that there was a probability of damage from drainage, which could be determined only by drilling tests; that there was no positive evidence of oil under the land and nothing but exploration and test by drilling could determine whether it was there in paying quantities; that defendant had not drilled for that purpose nor had any dry well been drilled on the premises; that defendant had no intention of making further exploration or development on its own initiative; that the land was worthless for drilling purposes; and concluded that if it was worthless it was not equitable and just to permit respondent to hold this large tract of land as a cloud on petitioners' title. And calling attention to the fact that the defendant's diligence in exploring the premises was of paramount importance, concluded that respondent had not shown that diligence as required in law, equity and good conscience; that plaintiffs had no remedy at law; that the defendant had not in good faith and with reasonable diligence explored and developed the land in accordance with the express and implied covenants of the lease; and that it would be inequitable to permit them to hold and retain it without further exploration or development as it proposes to do. Adding to the facts found by the court, the admission by respondent that its geological records showed that the Northwest corner of the lease had not been developed as thoroughly as the edges and that it was not

impossible of further development in that Northwest corner, certainly there is ample evidence to support all of these findings of the court and the conclusions drawn therefrom are the natural inferences which fairness and equity would dictate.

2. Brewster vs. Lanyon Zinc Co.

Respondent relies so strongly on *Brewster* v. *Lanyon Zinc Co., supra,* that we shall submit an analysis of this Brewster case and the Sauder case, confident that the principles of the Brewster case support petitioners' contentions. It is the leading case in American jurisprudence on the subject of "Implied Covenants Diligently to Explore," decided in 1905, Justice Vandevanter, writing the opinion. It is a Kansas case, seeking to forfeit an oil and gas lease on land in Allen County, Kansas, and to cancel it as a cloud on plaintiff's title. The court was considering an implied covenant to continue exploration and development after the expiration of the fixed period of development, during which oil had been discovered in paying quantities, and whether a breach of said covenant had been committed. As it is cited as authority in both the majority and dissenting opinions in the instant case, an analysis should prove interesting.

BREWSTER VS. LANYON ZINC CO., (C. C. A. 8) 140 Fed. 801:

	Brewster Case	*Sauder Case*
	(a) THE LEASE	
1. Subject:	Oil & gas and right to search and produce	The same
2. Nature of action:	Suit in equity to establish forfeiture and cancel	Suit in equity to cancel
3. Dates of lease:	October 28, 1895	June 6, 1915
4. Primary term:	5 years	10 years—or as long as oil or gas can be procured in paying quantities;
5. Acreage:	312½ acres—3 separate and distinct tracts, only 2 finally involved, 8 miles apart	360 acres in one block
6. Rights of lessee:	To oil and gas under premises with right to enter for purpose of drilling; To erect structures, pipe lines, etc., and remove same; To excavate for and use water,	To enter upon, operate for, and procure oil and gas; To erect pipes, structures, machinery and remove same; To use water and drill for or make ponds necessary for op-

	gas, and oil necessary to operate	eration; To discharge encumbrance and have a lien therefor;
7. Express covenant as to drilling:	One well to be drilled within 2 years, or Pay $78.00 annually until drilled; If no well is drilled within 5 years, lease null and void; Rental to be deposited in bank to credit of lessor; Failure to comply with covenants renders lease void;	Commence well within 1 year—in default, lease to be canceled on notice, or Pay annual rental $1.00 acre from year to year until a well is drilled; Rental to be deposited in bank to credit of lessor;
8. Lessor receives:	1-10th of oil; Gas for domestic use; $50. per each well from which gas is used off premises	1-8th of oil; Gas for domestic purposes; $100. per year for gas, if sold;
9. Duration:	Lessee's rights available to successor or assigns;	Contract binding on heirs, assigns, successors and personal representatives of the parties;
10. After primary term:	No express covenant for development after primary term;	No express covenant to explore after primary term;

(b) FACTS *re* EXPLORATION—
PAST AND FUTURE.

11. Exploration, etc.:	Well drilled in 5th year producing gas in paying quantities—has since been produced and used; No further development up to time of suit (14 months after expiration of primary term); $50.00 annual payment for gas may have been paid;	Two wells drilled (1921-1922) which then and ever since have produced oil in paying quantities; No further development up to time of suit—approximately 14 years; No gas;
12. Surrounding territory:	Many oil and gas wells drilled in adjacent and surrounding territory which furnish oil and gas in paying quantities;	76 producing wells on land adjacent; 84 on other close surrounding land—and from Mississippi Lime which underlies Sauder lease, practically all drilled after Sauder wells—66 of them from same lime formation depth as under Sauder lease. Lessee owns land adjacent on East, Southeast, and South on which it has 30 producing wells;

13. Drainage:	Drainage doing damage—extent not susceptible of ascertainment.	None of wells on adjacent land are "offsets." Geologist thinks no drainage. Court found evidence not convincing, could not be determined except by drilling, but some probability that damage being done.
14. Oil prospects:	No other facts than above;	Geologists and practical oil men say there is none, but admit it is opinion and not certain and could tell more certainly by drilling; Court finds no positive evidence by either party and nothing but exploration by drilling will determine; Northwest corner not impossible of development;

15. Lessee's contention:	By drilling single well, acquired right to oil and gas, and to hold indefinitely without further development, or doing more than paying $50.00 per year for gas;	By drilling single well, performed covenant, secured oil in paying quantities and entitled to hold; no breach because reasonably prudent man wouldn't drill;
	No facts with reference to whether a reasonably prudent man would or would not drill;	
	Purposes to hold for speculative purposes	No immediate intention to develop further; will, if some one else proves the field in the vicinity—claims worthless for oil drilling purpose;
16. Notice by lessor to cancel:	Lessor gave notice in writing 7 days before filing suit.	Lessor made demand to drill on lease about four years before suit was filed and lessee refused because had a valuable lease;

(c) Principles Established by Brewster Case.

1. Only method of determining whether or not particular lands contained oil or gas in paying quantities was by drilling to considerable depth (806);
2. Implied obligation to explore, develop and produce with reasonable diligence for common benefit of both parties (810) if during primary period oil and gas are produced in paying quantities (811);
3. Promise of royalties to lessor is controlling consideration (810);
4. Obvious difficulty in establishing amount of oil and gas in premises, or amount diverted therefrom, a serious obstacle to recovery of adequate damages at law (812);
5. Compliance with covenant to continue with reasonable diligence the work of exploration, development and production, after primary term, if during that time, oil and gas is found in paying quantities, is made a condition, the breach of which entitles lessor to avoid lease (812-3);
6. What constitutes breach is question of fact under particular circumstances (813);
7. Neither lessor nor lessee is arbiter of extent to which, or the diligence with which operation shall proceed, but both are bound by standard of what is reasonable (814);
8. No breach unless absence of diligence is both certain and substantial in view of actual circumstances at the time, as distinguished from expectation of lessor and conjecture of mining enthusiasts. It is only to end that oil and gas shall be extracted with benefit or profit to both that reasonable diligence is required;
9. Whether diligence is exercised depends on (1) Quantity of oil and gas capable of being produced from the premises as indicated by prior exploration and

development; (2) The local market demand and means of transportation; (3) Extent and result of operations on adjacent land; (4) Character of natural reservoir—as to drainage; (5) Usages of business (814);

10. Whatever under the circumstances would be reasonably expected of operator of ordinary prudence, having regard to the interest of both lessor and lessee is what is required (814). A plain and substantial disregard of this requirement constitutes a breach of the covenant for the exercise of reasonable diligence.

(d) Application of Principles to Facts—Brewster Case.

The circumstances under which the right to avoid lease have arisen are:

1. 2 Tracts—8 miles apart—213.5 acres;
2. Both tracts within recognized oil and gas field;
3. Lessee drilled one well and found gas in paying quantities;
4. No additional wells drilled or attempted;
5. Many wells drilled in adjacent or surrounding territory which produce oil or gas in paying quantities;
6. Wells adjacent are so near as to drain;
7. Extent of drainage not susceptible of definition;
8. Lessor cannot be compensated adequately in damages (815);

These circumstances compel the conclusions that:

(a) Show not only an absence of reasonable diligence on part of lessee but a practical repudiation of controlling purpose of lease and a persistent disregard of rights of lessor (815);

(b) Existence of gas in paying quantities is an ascertained fact (815);

(c) Both oil and gas are produced in paying quantities in surrounding land;

(d) Necessary inference is that further exploration and development would have been profitable to lessee as well as benefit to lessor (815);

(e) Prolonged failure of lessee to proceed with contemplated operations was plain and substantial breach of covenant and condition in respect of exercise of reasonable diligence and entitled lessor to terminate (815-6);

(f) Amount of oil and gas not susceptible of ascertainment (816);

(g) Attitude of lessee such that breach promises to be continuing one—and by reason of migratory character of oil and gas, to be injurious to and destructive of lessor's rights (816);

(h) Remedy at law not adequate (816);

(i) Lease is cloud on lessor's title, is destructive of valuable property, is productive of irreparable injury and calls for measure of relief not attainable at law (817);

(j) No objection to forfeiture when that is more consonant with principles of right, justice and morality than to withhold equitable relief (819);

(k) Decisions by Supreme Court of Kansas are in harmony with this view of right to forfeiture (819);

From the foregoing analysis it appears that the terms of the leases are almost identical in substance. If anything, the Sauder case presents a stronger situation on behalf of the lessor in that there is a larger acreage involved, 14 years of activity as compared with 14 months, more definite information as to producing wells on adjacent land, definite production in the lime at the same

depth as the respondent testifies is beneath the Sauder lease, a definite intention not to further develop. The Sauder case presents every circumstance under which the court held the lessor in the Brewster case had the right to avoid the lease except the latter case has the more definite facts as to drainage. Reference to the facts in the statement of the case and the findings of the court show that in the instant case we have 360 acres, within a recognized oil field, ~~one~~ two wells drilled on the premises in question which produced oil in paying quantities, no additional wells drilled or attempted for approximately 14 years, many producing wells in adjacent or surrounding territory, no definite testimony as to the drainage, and the finding of the court that there is a probability of damage from drainage, ascertainable only by drilling, which circumstances compel the same conclusion as stated in the Brewster case: That the existence of oil in paying quantities is an ascertained fact, oil is produced in paying quantities in adjacent and surrounding territory, a necessary inference that further exploration and development would have been profitable to both lessee and lessor, that the failure to explore shows not only an absence of reasonable diligence, but a practical repudiation of the controlling purpose of the lease and a persistent disregard of lessor's rights, that the prolonged failure to proceed is a plain and substantial breach of the implied covenants to exercise reasonable diligence, that the amount of oil is not susceptible of ascertainment, that the attitude of the lessee indicates a continuing breach during which the

lease would be a cloud on lessor's title and be destructive of valuable rights, and that the lessor is entitled to have his lease canceled.

It is significant, that the Brewster case involves a Kansas oil and gas lease, and that that case held that the decisions of the Supreme Court of Kansas are in harmony with the views expressed by it with reference to the right of forfeiture.

We do not think that respondent, experienced in the migratory character of oil and the uncertainty and fallibility of geologic inferences, should be permitted to take the position stated by Circuit Judge McDermott that:

> "Their science is valuable to condemn the lease in court in justification of a failure diligently to develop; but he will not back their testimony by relinquishing the lease" (R. 98).

Respondent's Vice-President frankly stated that he wants to hold it because there may be oil under it. That must be true, otherwise he would not go to the expense and inconvenience of defending this lawsuit. To that extent he does not accord verity to his own geologists. In holding the land for speculative purposes and taking a gamble at the expense of the lessor, there is no due regard for the interest of the lessor. That was a part of respondent's contract, and under any rule of law and fair dealing, the facts of this case should not permit the lessee to hold this property any longer.

VI.

CONCLUSION.

The matter involved, affecting title to real estate in connection with which there is an implied covenant that lessee will fairly exhaust the capability of the lease to produce oil by diligent exploration under the Kansas decisions, which should be followed by the Federal court, which covenant has been breached, the lease should be canceled; or on the respondent's theory for the reasons hereinabove stated there has been not only an absence of reasonable diligence, but a practical repudiation of the controlling purpose of the lease and a persistent disregard of the lessor's rights, under a set of facts where a reasonably prudent operator, having due regard for the interest of the lessor and the lessee, long ago would have done further exploration and development. Therefore, on either theory of the case, petitioners are entitled to a cancellation of the lease as decreed by the trial court.

Respectfully submitted.

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